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Agenda Item 6

June 13, 2011

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Manager Development Program (MDP) – Manager Transition

II. PROGRAM: Global Equity

III. RECOMMENDATION: Staff and Wilshire Associates recommend the Investment Committee:

(1) Approve Stux Capital Management for transition from CalPERS MDP program to CalPERS Mainstream Domestic Equity program via the exemption from competitive bidding process, in order to meet CalPERS contracting policies; and

(2) Approve the use of an annual review contract for Stux Capital Management.

Wilshire Associate's opinion letter is included as **Attachment 1**.

IV. ANALYSIS:

Background

The Manager Development Program I (MDP I), which began in May 2000, is an innovative program in which CalPERS provides venture capital and investment funds to emerging money management firms in exchange for a significant but minority equity stake in the selected firms. Two advisors, Progress Investment Management (Progress) and Strategic Investment Group (Strategic), were selected to assist staff in sourcing, monitoring, and developing the emerging firms. MDP I was created with a finite period of 12 years and staff and Progress were successful in winding down the Progress portfolio last year. With less than a year left, staff and Strategic have begun to wind-down the Strategic relationship. Stux Capital Management is the last remaining firm in the program.

At the August 18, 2003 meeting, the Investment Committee adopted the Manager Development Program (MDP) Transition Policy, is Attachment 2. The intent of the policy was to address the process of transitioning MDP firms into CalPERS mainstream global equity portfolio by having the MDP firms enter into a direct contractual relationship with CalPERS for the management of assets. There are three criteria that must be met in order for an MDP firm to be considered for transition:

- The MDP firm has been successful in attracting other corporate or public pension funds or endowment/foundation clients, regardless of the size of assets awarded
- The MDP firm has competitive risk-adjusted performance
- Additional assets allocated to the MDP firm's investment approach and style will enhance CalPERS overall manager structure in the relevant asset class

Stux Recommendation

Stux was funded through CalPERS MDP I program via CalPERS partnership with Strategic Investment Management. Stux was the last firm to be funded in MDP I and in February 2004 CalPERS allocated $200 million to the firm's US Large Cap Core product. In addition to the allocation, CalPERS obtained a 35% equity stake in Stux. As of April 30, 2011, Stux currently manages $534 million on behalf of CalPERS.

Stux was founded by Ivan Stux in 2001 with CalPERS being one of the initial investors in the firm. Prior to founding the firm, Mr. Stux was a principal at Morgan Stanley serving as head of analytical and quantitative research and development for equities, trading, and quantitative strategies. Stux provides US Large Cap Equity products and offers a unique approach, utilizing two distinct proprietary alpha generating models. First the sector rotation model harnesses top-down macroeconomic information, whereas the stock selection model uses an array of bottom-up company fundamental analysis. The two models together significantly decreases volatility creating a process that tends to mitigate short-term underperformance and provide strong alpha over the long-term.

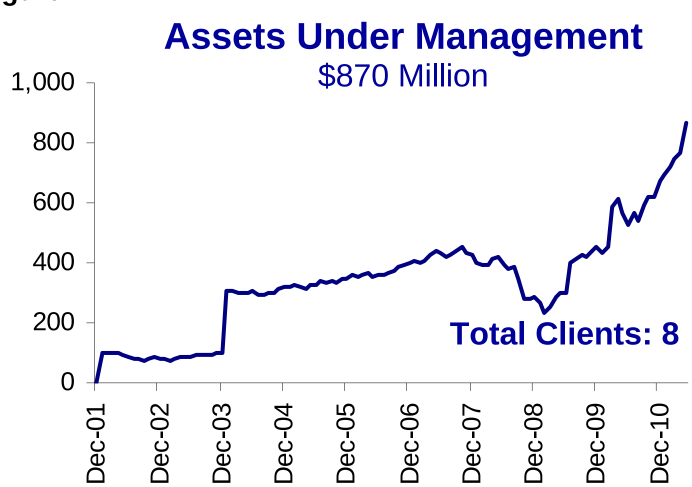
As outlined in the MDP Transition Policy, Stux meets the following three requirements:

1. <u>Success in Attracting Other Clients</u>

Since joining MDP in 2004, Stux has been successful in gaining new clients. The first few years proved difficult for Stux with no growth in assets; however, this was anticipated as CalPERS was an initial investor in Stux and the firm's intent was to use the investment from CalPERS towards research and expanding the quantitative models and investment process. Stux was then faced with one of the most difficult market environments to raise assets in, as after the market crash in 2008 most institutional investors were pulling assets out of equities. Performance at the firm remained strong and Stux was able to hire a full time marketer to assist the firm in growing assets. Since that time Stux has seen some recent success and current assets under management have grown from $200 million to close to $1 billion. Additionally, Figure 1 below illustrates Stux' growth in client relationships and accounts.

Relationships and Accounts

Figure 1



2. <u>Good Risk-Adjusted Performance</u>

Tables 1 and 2 below illustrate Stux' relative and risk-adjusted performance for the US Large Cap Core product as of April 30, 2011. Stux has outperformed its custom benchmark in all time periods, net of fees, with the exception of 2008 which was an extremely difficult year for all active managers.

Stux Annualized Return

Table 1

Performance through 4/30/11	**1 Year Annualized**	**3 Year Annualized**	**5 Year Annualized**	**Inception* Annualized**
Stux Capital	19.99%	2.64%	3.97%	5.50%
FTSE TMI 1000*	17.78%	2.11%	3.24%	5.17%
Excess Return	**2.21%**	**0.53%**	**0.73%**	**0.33%**

*Inception Date: 2/1/2004. Source: State Street Bank. Returns are net of fees and CFA Institute compliant.

Stux Calendar Year Return

Table 2

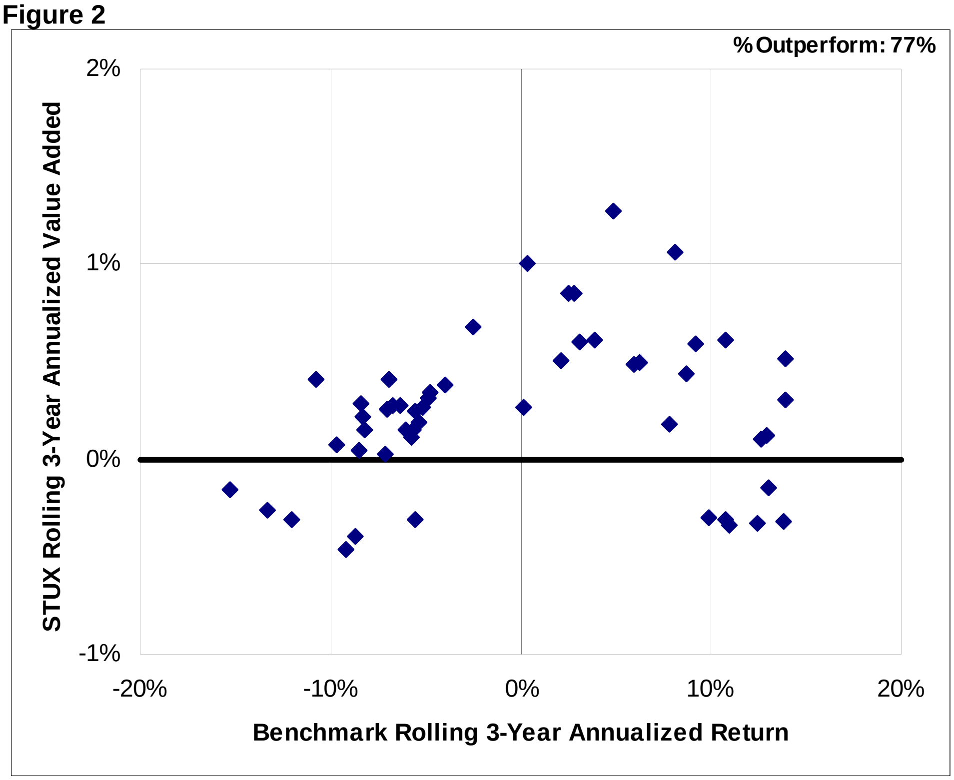
Calendar Year Performance	**YTD 4/30/11**	**2010**	**2009**	**2008**	**2007**	**2006**	**2005**
Stux Capital	10.18%	18.22%	31.28%	-39.10%	6.63%	15.69%	7.31%
FTSE TMI 1000*	9.41%	15.95%	28.49%	-37.90%	6.13%	15.46%	6.27%
Excess Return	**0.77%**	**2.27%**	**2.79%**	**-1.20%**	**0.50%**	**0.23%**	**1.04%**

Source: State Street Bank. Returns are net of fees and CFA Institute compliant.

Figures 2 and 3 below illustrate Stux' rolling three year annualized return versus its benchmark. Figure 2 demonstrates that Stux has been able to add value 77% of the time on a net of fee basis. Figure 3 illustrates Stux' ability to add value consistently across all time periods.

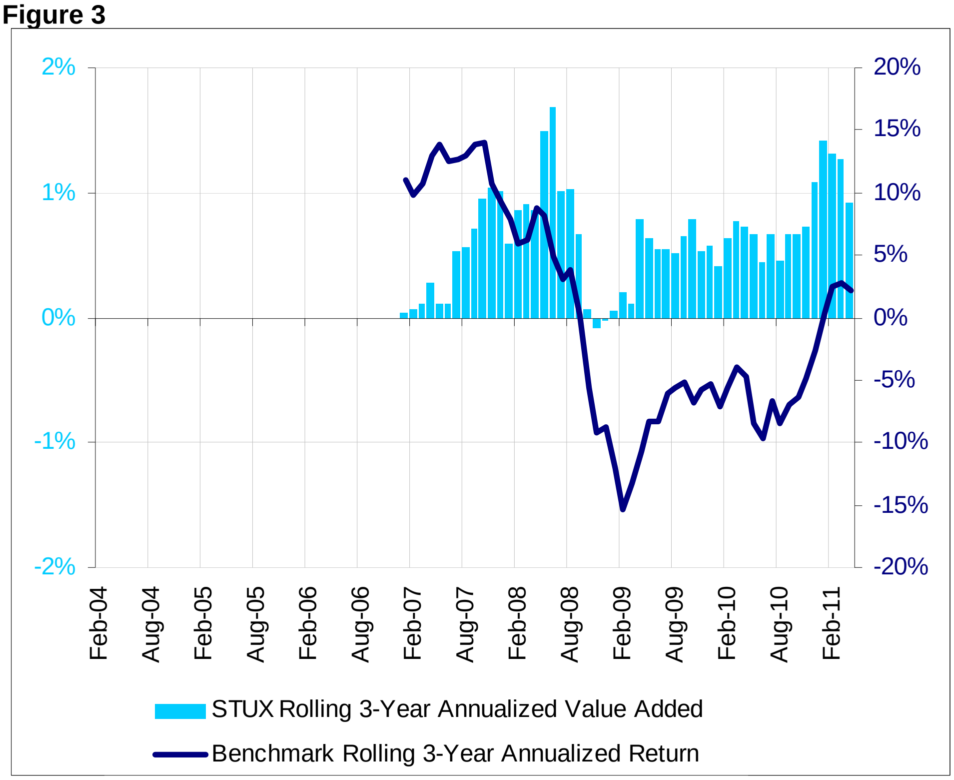
Rolling 3-Year Active Return

Figure 2



Performance Consistency

Figure 3



3. Enhance CalPERS Global Equity Portfolio

Stux' equity strategy complements both existing U.S. equity strategies as well as all the strategies within the Global Equity Portfolio. Stux' Large Cap Core strategy focuses on large capitalization stocks and targets a 2-4% tracking error. The firm's unique process of combining two separate models, the sector rotation model and stock selection model, results in a lower volatility without compromising alpha potential and cannot be internally duplicated. Stux' strategy, based on excess returns, has a relatively low correlation to Global Equity's strategies as illustrated in Table 3 below. Low correlations imply greater diversification and provide a wider range of return opportunities given that the manager's sources of return are not highly correlated with one another.

Correlation

Table 3

Correlation Matrix	Stux	U.S. Portfolio	Total Global Equity
Stux	1.00	0.12	0.02

Additionally, Stux has been approved through Global Equity's newly implemented capital allocation process. Transitioning Stux from the MDP program to a direct contract structure will allow Stux to continue to manage assets uninterrupted, therefore continuing to add value for CalPERS, as demonstrated by their consistent outperformance since inception February 1, 2004. Furthermore, since Stux is the last remaining firm in the MDP I program, this transition will allow staff to successfully close MDP I and focus on the two remaining emerging manager programs, MDP II and Emerging Manager Fund of Funds.

Annual Review Contract & Best Business Practice Exemption

Staff recommends the use of an annual review contract. This process provides CalPERS with an annual opportunity to review the manager's performance with respect to the terms of the agreement and determine whether to continue the relationship or terminate. This is consistent with the contracting procedure used for all other investment management contracts. CalPERS ability to monitor the performance of managers with such lengthy contract terms, and to make corrective action (including expeditious termination of the contract) is necessary to fulfill the Board's fiduciary duties. The ability to define contract duration is permitted under Board Resolution 92-04B-4.

Pursuant to Board Resolution 92-04B-2, an exemption from competitive bidding can be approved by the Board if they have determined that a new or current contractor can competently and expeditiously provide the specific services; and can do so at a reasonable fee; and that the selection is based on a CalPERS Best Business Practice decision.

The exemption from competitive bidding request, which staff believes meets all the necessary requirements, is shown in Attachment 3.

Summary

Staff and Wilshire Associates recommend Stux Capital Management for transition to CalPERS Mainstream Global Equity portfolio. Stux has met the requirements in all three areas defined in the MDP Transition Policy and in the CalPERS Exemption from Competitive Bidding Resolution; therefore, staff is seeking Investment Committee approval for: 1) an exemption from competitive bidding process for Stux based on a best business practice decision (CalPERS Board of Administration Resolution No. 92-04B-2), and 2) the award of an annual review contract.

V. STRATEGIC PLAN:

This item addresses Strategic Plan Goals VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first to pay benefits and second, to minimize and stabilize contributions; and IX, achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

Staff plans to negotiate a reduced fee schedule from what CalPERS is currently paying to Stux and the fee paid to the partner, Strategic, will be eliminated. This fee will incorporate performance-based incentive fees. Approval of this recommendation is subject to successful fee negotiations.

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